Canada

Brief to the Royal Commission on Banking and Finance

[Submissions]

VOLUME I

FOREWORD

RECOMMENDATIONS AND SUGGESTIONS

SUMMARY OF APPENDICES

Submitted June, 1962 by

THE INVESTMENT DEALERS' ASSOCIATION OF CANADA

V O L U M E I

Table of Contents

Submitted June, 1962 by The Investment Dealers' Association of Canada

F O R E W O R D

In planning the preparation of this Brief, The Investment Dealers' Association of Canada gave consideration to the size and scope of the subjects to be considered. The Association concluded that it would either have to obtain the services of professional consultants or that it would have to break up its presentation into a number of subjects and have one or more of its Members prepare memoranda on an assignment basis. It was appreciated that the latter method would produce considerable variety in style and approach, but these drawbacks were thought to be more than compensated for by the intimate knowledge on which our Members could draw in dealing with the subjects at hand. The memoranda supporting this Brief were, therefore, prepared on a "committee" basis.

The Association regrets that certain statistical and financial information which the Commission would like to have and, which it would like to offer, is not obtainable. Neither the individual firms nor the industry as a whole, have maintained records of the type which would enable detailed answers to some of the questions asked by the Commission on internal operations. In some cases, this information is not obtainable because of the overlapping nature of the stock, bond, money market and underwriting business. However, the trend toward centralized record-keeping, through the use of computers, may provide the information for more detailed analysis in the future.

A. J. Milner

President

The Investment Dealers' Association of Canada.

June, 1962

RECOMMENDATIONS AND SUGGESTIONS

The following recommendations and suggestions are derived from and supported by the evidence and exhibits comprising Appendices A - N. These recommendations and suggestions appear in more detailed form at the end of the various appendices. A minority of members have indicated that they do not concur with those marked with an asterisk (*).

THE INVESTMENT DEALERS' ASSOCIATION OF CANADA RECOMMENDS OR SUGGESTS:-

with respect to

I. GOVERNMENT OF CANADA ECONOMIC AND FISCAL POLICY:

	REFERENCES Appendix	Paragraph
1. that a sound fiscal policy be adopted immediately by the Government of Canada; that inherent in this policy be the objective of approximately equivalating budgetary deficits which may be incurred in recession years with surpluses in years of prosperity and that this policy be considered essential to the effective operation of the Bank of Canada and the maintenance and growth of a broad market for capital in Canada;	B C Exhibit 44 F	22, 32-40 62-74 32-39
2. that the Commission examine the areas of conflict between debt management and control of currency with a view to determining whether these functions should be separated;	B C Exhibits 5-7	14-16 8-13
3. that the Commission examine the Bank of Canada's role in operating the purchase fund and its trading for Government accounts with a view to determining whether these functions should be handled by the Department of Finance or other trading agencies;	B F	14-16 50

RECOMMENDATIONS AND OBSERVATIONS

The following recommendations and observations are derived from and supported by the evidence and analysis contained in Appendices A - H. These recommendations and suggestions appear in more detailed form at the end of the various appendices. [illegible]

[illegible]

with respect to:

1. [illegible]

APPENDIX	REFERENCE PARAGRAPH	
		1. That a [illegible] immediately by the Government of Canada. This [illegible] particularly [illegible] may be [illegible] in terms of [illegible] the [illegible] of a [illegible]
		2. That the [illegible] of conflict between [illegible] currency, with a [illegible] functions should be [illegible]
		3. That the [illegible] to [illegible] its [illegible] determining [illegible] the [illegible]

	REFERENCES Appendix	Paragraph
4. that the Commission examine the Government's exchange policy with a view to determining the adequacy of our exchange reserves, our position vis-a-vis the International Monetary Fund and the desirability of a "pegged" rate;	C	36, 37 Exhibits 22-23
5. that the Commission consider the valuable contribution of foreign capital to Canada's post-war development and recommend policies intended to maintain a favourable investment climate in Canada to ensure that this capital be available, if and when needed;	J	59
6. that, to the extent that it is necessary or desirable to import capital from foreign countries, Government of Canada policies be established which will encourage the purchase by foreigners of debt securities rather than equity investments of all kinds;	M	35-44 Exhibit 2
7. that the Commission examine the question of withholding tax on all foreign flows of short term investments into Canada's money market with a view to recommending that they be not discriminated against because they have little influence on the factors affecting non-resident control of Canadian resources and manufacturing;	G	57
8. that the federal budget address be delivered during the month of April each year;	F	31
9. that an informative public statement on the state of the nation be made by the Federal Government annually during the month of October;	F	31

	REFERENCES	
	Appendix	Paragraph
10. that a standing committee composed of men from The Investment Dealers' Association of Canada having experience and independent judgement in the marketing of Government of Canada Bonds be established by Government decree to act in an advisory capacity to the Bank of Canada and the Department of Finance in connection with such matters as the marketing of Government of Canada issues and open market and trading operations;	B C Exhibit 7 I	61-65 9-13 21-28 35 13-19 46
11. that an annual sinking fund of 1% of the principal amount of Government of Canada issues with maturities in excess of three years be established;	B	13
12. that the Commission examine the advisability of placing less emphasis on Government financing through Canada Savings Bonds and inquire into the proper maximum limit of purchases of these Bonds consistent with maintaining them as a true savings instrument;	B C	26-32 9(v)
13. that the Government at the time of issue offer at least a substantial portion of all new issues to the public through normal channels at advertised prices;	B C F	63-64 10 48
* 14. that the financing of the Canadian National Railways and other Government agencies be arranged through large national syndicates composed of investment dealers;	B C Exhibit 7	66 13
15. that, with the exception of 13 and 14 above, the present economic and efficient methods employed in Canada for treasury bill financing, marketing of Government of Canada and provincial issues be continued;	B	42-59 67-76

with respect to

	REFERENCES	
	Appendix	Paragraph

II TAXATION:

16. that a Select Committee be formed to study and assess the entire tax structure of Canada with the objective of devising an improved taxation system better able to meet Canada's economic needs; that before holding public hearings such Select Committee carry out its initial deliberations on a confidential basis at the highest level in order to arrive at some definite conclusions under objective conditions; that such Select Committee be composed of highly qualified individuals having a broad working knowledge of the present tax structure with most emphasis being placed on its practical operation in business and in the economy as opposed to its legal and accounting operation and that such a Committee be composed primarily of representatives of business from members of The Canadian Chamber of Commerce and Boards of Trade, representatives of finance from members of The Investment Dealers' Association of Canada and The Canadian Bankers' Association, practical economists, representatives of the Canadian Tax Foundation, and, secondarily of members of the legal and accounting professions;

Appendix	Paragraph
N	35 (2) (i) (ii) + (iii)

17. that the Commission consider recommending that the twelve specific areas of our tax structure outlined in Appendix N be carefully studied, with particular reference to:

	Appendix	Paragraph
17.	N	14-33
(a) an incentive method of applying taxation;	N	23
(b) the use of indirect taxation as an alternative or partial alternative to personal and corporation income tax;	F	38 (2)
	N	19-22
(c) the tax disadvantage to Canadians, compared to U.S. citizens and corporations, in respect to the development of Canadian oil and gas natural resources;	J	66
	N	31

		REFERENCES	
		Appendix	Paragraph
(d)	the merits of the 20% tax credit and to the further reduction of double taxation in Canada;	I J N	17 22-25 26, 27
(e)	the requirement of the Canadian economy for continuing and substantial growth in which an ever increasing quantity of equity capital is essential and which indicates that any capital gains tax would be inadvisable and not in the best interests of Canada; and	N	29
(f)	the merits of enabling a taxpayer to obtain a tax ruling prior to a transation;	N	30
18.	that corporate income tax legislation be amended to permit companies to deduct financing costs as expenses;	E	50

with respect to

III. BANK OF CANADA:

19.	that the Bank of Canada Act be amended generally to clarify the Bank's relationship with the Government and particularly to establish an improved procedure for the resignation of the Governor of the Bank of Canada either by his own volition or by request of the Government or Parliament;	C Exhibit 4	7
20.	that the Commission examine the use of "moral suasion" by the Bank of Canada to influence such things as stock margins, instalment sales, term lending by chartered banks and the reserves of "near banks";	C Exhibits 31-42	44-60
21.	that the Board of Directors of Bank of Canada be selected from men experienced in matters of finance and business;	C Exhibit 12	18, 19
22.	that direct participation of the Board of Directors of the Bank of Canada in policy making be established by having the executive committee of the Board meet fortnightly and the Board as a whole meet monthly;	C	19

	REFERENCES Appendix	Paragraph
23. that, in order to convey to the nation the economic health of the country, an administered bank rate be re-established;	C Exhibits 28-30 F	41-42 40
* 24. that, in order to continue to foster the growth of the money market, the right of participants to sale and repurchase agreements with the Bank of Canada to the extent of their lines of credit and at the average weekly tender for 90 day bills plus ¼ of 1% be continued; (for minority view see Appendix C-43)	B G	19-21 45-48
25. that closer liaison be established between the Bank of Canada and the money-market dealers for the purpose of trading in money-market securities;	G	48
* 26. that the Commission consider recommending that the agreement between the chartered banks and the Bank of Canada in 1956 establishing secondary reserves be terminated;	C Exhibits 26, 27	40, 60
27. that the Bank of Canada be urged to publish from time to time pamphlets intended to clarify the Bank's functions and actions;	C Exhibit 11 F	17 53
* 28. that the trading departments of the Bank of Canada in Toronto and Montreal be given more authority;	C Exhibit 20	29-30
29. that the Bank of Canada be urged to institute a programme designed to expedite its replies to firm bids or requests for firm offerings from dealers;	F	46

with respect to

IV. SECURITIES REGULATIONS:

30. that S.E.C.-type legislation be not established in Canada and that the Commission take note of the progress already achieved towards uniform securities legislation uniformly administered and the work presently in progress to achieve this objective;	E	51-54

	REFERENCES	
	Appendix	Paragraph
31. that the Commission examine the protection provided under the securities acts for shareholders of both open and closed end investment trusts and mutual funds and make recommendations for such additional regulatory legislation as may be deemed advisable;	K	112-117 123
32. that the various securities acts be amended to permit the distribution of preliminary prospectuses to prospective securities purchasers;	E	57

with respect to

V. JUNIOR GOVERNMENTS:

33. that the Commission consider recommending that use of savings loan type issues by provincial governments be sharply curtailed;	B	33-40
34. that life insurance companies be permitted to evaluate holdings of municipal securities at the amortized book value in the same manner as for federal and provincial securities;	D	22
35. that school debentures, owned by non-resident insurance companies, be accepted for deposit by the Federal Department of Insurance;	D	23
36. that no change be considered with respect to the tax status of interest payments on municipal debentures.	D Exhibit E	24

with respect to

VI. CHARTERED BANKS:

37. that every encouragement be given to the continued healthy development of the investment dealer's ability to perform satisfactorily the important underwriting function, and, in particular,

	REFERENCES	
	Appendix	Paragraph
(a) that the banks continue to refrain from making term loans in excess of a reasonable limit in amount to business corporations where the time of repayment is deferred beyond that of ordinary bank loans and from purchasing a security negotiated directly with the customer as distinct from buying a publicly issued security in the market and	H	28 41-42
(b) that there be no further extension beyond the relatively few cases of long standing which may exist, of the inclusion of banks in syndicates underwriting corporate securities for resale to the public, particularly where such inclusion would place the bank in the dual position of banker and underwriter and where the sale of corporate securities is for the purpose of paying off bank loans;	H	44-49
38. that section 91 of the Bank Act and section 71 (1) of the Quebec Savings Bank Act, which sections impose a ceiling of 6% on rates that may be charged on bank loans, be repealed;	H	14-17
39. that the chartered banks be encouraged to adopt policies and procedures resulting in their call loan interest rate schedules being subject to periodic review and to take appropriate action to keep these rates in line with market conditions and competitive rates from other sources;	H	3 -13
with respect to		
VII. FINANCING SMALL BUSINESS:		
40. that the Commission consider recommending that special tax advantages be given to investment companies specializing in financing small businesses;	L	13
41. that the Commission consider recommending that the proceeds from loans to small businesses by institutional investors be subjected to a reduced corporate tax burden in order to encourage this type of financial activity;	L	2, 5, 9 10

	REFERENCES	
	Appendix	Paragraph
42. that the banks and insurance companies be encouraged to apply a portion of their funds to the financing of small businesses through equity purchases or long-term loans to small business investment companies similar to those operating under the Small Business Administration Act of the United States;	L	3, 5, 8, 9

with respect to

VIII. MISCELLANEOUS:

43. that the difficulty of obtaining accurate statistics for assessing the roles of the various borrowers in the money market be recognized and that more information be obtained and published concerning the borrowing by provinces, municipalities and corporations in the money market;	G	16, 24 29, 36 49
44. that the inadequacy of the statistical material available concerning stocks and stock ownership be recognized and that the Dominion Bureau of Statistics assemble and publish this material;	J	20, 27 31
45. that the Commission examine the participation in the stock market of Canadian financial institutions and pension funds in comparison with those in the U.S. and make such recommendations as will encourage increased participation by them;	J	65 Table 15
46. that the Commission examine the important matter of expropriation of electric utilities with a view to recommending that the Federal Government devise means to minimize the temptation to expropriate arising out of Federal tax treatment of the provinces;	E	57

	REFERENCES	
	Appendix	Paragraph
47. that the Commission examine shareholders rights in the light of certain recently employed "take-over" techniques;	E	58
48. that the Commission examine the Companies Act of Canada with a view to recommending removal of certain anomalies in it which tend to deter the incorporation of companies under its provisions.	E	59

That in its deliberations on this and other submissions the Commission be aware that the Investment Dealers' Association of Canada believe it to be in the best interest of Canada, that, insofar as is possible, the changes which the Commission deems it advisable to recommend be induced by the provision of suitable incentives rather than through legislative action.

SUMMARY

(The following is a summary of Appendices A to N which contain the detailed evidence supporting this Brief.)

THE INDUSTRY AND THE ASSOCIATION

The Industry - Appendix A (part 1)

1. The investment business as we know it today dates back to the 1880's. At the outbreak of the 1st World War, over three-quarters of all new issues of Canadian bonds were still being placed in London. It soon became necessary for Canada to turn to domestic sources to finance the war effort. In six loans the investment community was able to raise over $2.2 billion from 2.8 million subscribers. The magnitude and success of this effort stimulated the rapid development of the industry in Canada.

2. In 1920 a committee of dealers and banks was formed at the request of the Minister of Finance to deal with a heavy return flow of securities from London. Redistribution of $150 million of Victory Bonds was achieved and an orderly market maintained. During the 1920's over 80 new investment firms were formed. In this period the upsurge of industrial development induced a large volume of corporate financing. The size of new issues increased and the industry rapidly developed the methods of underwriting corporate and government securities, which, while modified and improved, are still in existence today.

3. Subsequent to 1929 the industry underwent a period of trial as earnings, tax collections and security prices declined precipitously. The disruption of markets which occurred when Britain went off the gold standard caused a serious crisis and impressed dealers with the need of speeding up the distribution of new issues. In general, the decline in volume of new issues in the 30's led to a greater emphasis on secondary market trading, a concentration on security analysis and an increasingly sophisticated approach to financial matters resulting in part from detailed work done on corporate re-organization and debt re-adjustment.

4. During the 2nd World War the securities business was centred in the work of the National War Finance Committee. In the war period over 23 million subscriptions were obtained for the various loans which totalled $13.1 billion.

5. As the post-war period began, the industry was convinced by its wartime experience that there could be a large increase in the securities business. Low interest rates, inflation, the liquidity of investors based on government bondholdings and the favourable economic environment encouraged a strong trend toward equity investment. Increased financial capacity and the employment of more highly trained staff enabled dealer organizations to underwrite and distribute larger issues and generally to expand their business.

6. The post-war period saw the Bank of Canada become the dominant factor in the high-grade bond market. Since the Bank introduced the money market in June 1954, investment dealers have generated a large volume of trading in short-term securities. The 1950's saw a great expansion in the sale of Canadian securities to foreigners. The post-war period illustrated again the ability of the industry to adjust to changing conditions, demands for funds and investor preferences.

7. As at December 31st, 1961, The Investment Dealers' Association of Canada (I.D.A.C.) had 189 Members directly employing 9,329 people, of whom 14.5% were partners and directors. A survey in August 1958 showed the industry employing 8,589 people in 196 firms. Thus, in this period, while membership declined by 7 firms, the number of personnel increased some 8%. These figures indicate a trend in the industry toward rising employment based on the need for a larger number of office workers, analysts, traders and the like to support each salesman. 110 I.D.A.C. members have staffs of 25 or less and of these some 60 employ less than 10 persons. In the main these small firms have been built on the knowledge, capital and sales ability of a few senior partners.

8. Appendix A (part 1) describes the internal organization of an

investment house. One important common denominator of all firms except those few which are controlled in the United States, is that without exception the officers, partners, and directors actively participate in the business.

9. The investment business in Canada is characterized by the great variety in the size, type of business, and the kind of clientele of the various firms. Broadly speaking, the integrated houses are the large national firms which underwrite, distribute, trade, and evaluate practically all types of securities. Distributing houses do not customarily originate industrial issues but participate in their distribution and carry on trading in outstanding securities. Specialty houses are those which restrict their business primarily to such areas as unlisted stock trading or buying and dealing in municipal or religious issues.

10. Underwriting is a principal function of the investment dealer. The dealer underwrites by buying all or part of an issue for his own account or jointly with others, by winning a public tender for securities and by negotiating new issues. While not underwriting in a strict sense other methods of acquiring new issues used by underwriting houses include arranging private placements and acting as agent for issuers. Underwriting firms form a key group in the list of primary distributors which the Bank of Canada uses for offering new Government of Canada issues. In provincial issues large national underwriting syndicates may negotiate for the purchase of the issue or in the case of smaller issues several such syndicates may bid at public tender. Municipal issues are bought by underwriters through public tender or purchases arranged by private negotiation. Government of Canada money market issues are dealt in primarily by 14 investment dealers and the chartered banks. The Treasury Bill segment of this market represents a large volume of transactions at very small margins. Bills are tendered for each week at public auction. Corporation issues are generally underwritten after direct and private negotiations between an underwriting house and the company. In these issues the investment

dealer assists in designing the issue in accordance with the requirements of the company and the current preferences of the market. The underwriting function as applied to the various types of securities outlined above, is described in detail in Appendix A (part 1).

11. Another major function of the investment dealer is that of trading in outstanding securities. Through his trading activities the dealer establishes and maintains markets and thus provides liquidity and establishes value levels for securities not listed on exchanges. Most dealers active in secondary markets carry inventories which enable them to conduct an orderly market and to deal in the size required by financial institutions. The street market of the dealers is handled by their traders. The larger firms will have a number of traders who may specialize in money market securities, Canadas, provincials, corporates and unlisted stocks. This trading is done through a network of direct telephones and other communications facilities on a truly national basis. The kingpin of this market is the Bank of Canada whose prices and actions with respect to money market securities and Government of Canada bonds provide the bench marks for the "government" market and for the evaluation of lesser securities. While market information is passed on by word of mouth, printed information, primarily quotations is disseminated regularly by some 25 dealers and the I.D.A.C.

12. A third and increasingly important function of the investment dealer is the provision of a variety of services. Advice to buyers, sellers, and issuers of securities is given through interviews, telephone communications, memoranda, analytical reports and the like. In addition, the dealer's growing business and the increasing sophistication of his clients is requiring provision of more information in the form of economic and industry studies, market commentaries, offering lists, notification of called bonds, etc. Portfolio management services are offered to clients by a number of dealers. The rapid growth in the demand for these services in recent years has necessitated that dealers expand their research and clerical staffs.

13. In contrast with other financial institutions, investment dealer organizations are small and characterized by a high degree of independence and individuality. Over the years they have adapted themselves to changing conditions in a manner which has resulted in a continual broadening of the Canadian capital market. Mr. J. E. Coyne, then Governor of Bank of Canada, in a public address made on December 14, 1959, stated:

> "....we also have in Canada a well developed nation-wide capital market, particularly in respect of the distribution of securities issued by governments, local authorities and business corporations. This is primarily the field of activity of investment dealers. I think there is little doubt that the financial machinery existing in Canada for the placing of new issues of securities on the market is the equal of that of any country in the world and, in proportion to our size, it probably arranges, year in and year out, for the provision of a greater quantity of new capital to those requiring it than is the case in any other country in the world. The results achieved are a reflection of the industry and enterprise and broad national outlook of our investment dealers....."

The Association - Appendix A (part 2)

14. The Association (The Investment Dealers' Association of Canada) was formed in June 1916 under the name of the Bond Dealers' Association of Canada with 32 members. By 1920, membership had grown to 104 and in 1939 there were 130 members. Peak membership of 206 was reached in 1958 and since this time membership has declined to 189. In 1925 the name was changed to the Investment Bankers' Association of Canada but with the passage of the Bank Act in 1934 use of the word "bank" was restricted and the name of the Association had to be changed to The Investment Dealers' Association of Canada (I.D.A.C.).

15. Membership in the Association is governed by its constitution and by-laws. Membership is open to all those carrying on business as investment dealers if it can be shown that at least one-half of their gross profits result from underwriting, distributing or buying and selling investment securities in Canada. It is required that at least 50% of the partners or officers and directors must have been in the investment business for at least five years. Minimum standards varying with the type and size of the business are set to prescribe the amount of capital each member must maintain. The by-laws of the Association have been continually amended to reflect the changing standards and requirements of the industry.

16. The I.D.A.C. is organized on a national basis and for its purposes Canada is divided into six districts with the chairman of each district executive committee being a vice-president of the Association. Each district has a Business Conduct Committee, and there is a National Business Conduct Committee. The National Association has a permanent executive staff at its head office in Toronto and at its branch office in Montreal. The I.D.A.C. is not directly comparable with associations in other countries.

17. A principal function of the I.D.A.C. is the protection of the investing public by endeavouring to maintain the highest standards of ethics and reliability. As a control the I.D.A.C. makes all members subject to periodic routine reviews of the type of business they conduct. The I.D.A.C. also devotes considerable time to the protection of its members and to the advancement of Association objectives by taking a broad interest in economic, legislative, tax and other matters. This brief is an illustration of that interest. While day-to-day control over securities trading is carried on by the Bond Traders' Associations of Toronto and Montreal, the I.D.A.C. exercises ultimate responsibility for regulating secondary trading.

18. Another prime function of the I.D.A.C. has been to provide education on investment matters for employees of its members and for the general public. Since the inception of the employee education programme in 1947, 5,996 persons have enrolled in the two courses provided and 3,601 have successfully completed at least one of these courses. A third course is now being prepared which is designed to improve employees' knowledge of the banking, accounting, contractual, regulatory and legal aspects of the investment business. Each year the I.D.A.C. has distributed through several universities a home study correspondence course entitled "How to Invest Your Money in Bonds and Stocks". A total of 20,000 persons have enrolled in these courses. Also in co-operation with universities and school boards, the I.D.A.C. has established lecture courses in which 1,700 Canadians were enrolled in 1961. By using voluntary speakers panels composed of members, the I.D.A.C. now provides about 100 public addresses a year for various organizations. Its film "A Matter of Importance" has received over 300 showings since it was produced in 1954. Through these and other means, the I.D.A.C. is making a serious effort to improve the public's knowledge and understanding of investments and the investment business.

19. Apart from occasional surveys, the I.D.A.C. has not been a statistics gathering body. The year-ends of its members are scattered throughout the calendar year and no two firms keep their books in the same way. It may be desirable in the future to standardize accounting practices to a greater degree. This would make the regular collection of statistics feasible. The I.D.A.C. does make a contribution by gathering and assembling figures on member borrowings outside of the banks, and, in co-operation with D.B.S., by assembling and distributing information on the sales and purchases of securities between Canada and other countries. Each business day the I.D.A.C. makes available quotations on a large and representative list of bonds and debentures

traded in Canada. The I.D.A.C. has prepared and produced a number of publications which have been found to be valuable within and without the industry. Copies of these are exhibited.

20. In addition to these specific functions, the I.D.A.C. has made important contributions by virtue of its liaison activities with many bodies such as the Canadian stock exchanges and the Canadian Bankers' Association.

FINANCE DEPARTMENT & FEDERAL & PROVINCIAL FINANCE - Appendix B

21. The Second World War brought about such great changes in the Canadian debt structure and in debt management that study of pre-war conditions would have no real significance. Also, the inflationary forces created during the war, together with the deferred demands for all forms of social capital, both from within Canada and from foreign countries, greatly stimulated capital expenditure. Low interest rates and rapid economic expansion induced a vastly increased volume of Canadian and foreign investment into the equity field. The public tended to reduce the proportion of federal government bonds in their portfolios and there was a growing reluctance on the part of many investors to apply more than a limited portion of their funds to long-term bonds. While certain important institutional groups are obliged to buy fixed income securities, even these tended to apply higher proportions to better yielding securities and equities. These developments have tended to narrow the market for long-term Federal Government bonds.

22. In the latter part of the 1950's, the government accepted the principle of deficit financing as a stimulus to a lagging national economy. Lack of investor interest in long-term debt securities necessitated the government financing its requirements largely in the short-term market and through Canada Savings Bonds, which latter, now comprise 22% of the government debt. These activities have tended to distort the bond market and reduce the liquidity of long-term bonds. The increasing dependence on financing through Canada Savings Bonds,

which are in effect demand obligations, rather than through term issues, is a regrettable trend.

23. The root of the problem is fiscal policy. It would probably have been impossible to finance the large deficits of recent years by other means. Fiscal policy should direct more attention to debt retirement in periods of prosperity. This, combined with provision of a fixed annual sinking fund of 1% per annum on all outstanding federal government issues over three years, would provide the market with the confidence it needs.

24. It appears that there is a tendency for debt management policy to be unduly subordinated to monetary policy and it is suggested that the Royal Commission inquire as to whether debt management and control of currency have conflicting interests and whether these functions should be separated.

25. It seems appropriate to study the possibilities of returning to an administered Bank Rate, which would clearly indicate the state of the Canadian economy. In order to foster the growth of the money market, the money market participants should continue to have the right to sale and repurchase agreements with the Bank of Canada, at the average weekly rate established at the tender for 90-day Bills, plus 1/4 of 1%.

26. In the last five years large federal government deficits have necessitated substantial increases in debt. Now, out of a total debt of $18.6 billion, only $8.4 billion or 45% is for a fixed period of over 3 years. Nearly $4.1 billion or 22% consists of Canada Savings Bonds. Savings Bonds are designed for individual investors of modest means. They encourage the ownership of liquid assets by a large number of

families who might not otherwise be inclined to save. Thus they play an important part in Canada's financing. However, in view of the large amount now outstanding and the high cost of this type of financing, we suggest that the Government should place less emphasis on financing through this type of medium and that the maximum to any one buyer be limited, consistent with maintaining a true savings instrument.

27. In Appendix B, a comparison is made between methods of financing short and long term government and provincial securities in Canada with the methods used in Great Britain and the United States. The Canadian methods appear to be well suited to the requirements of this market. Indeed, they represent a combination of adoption and evolution starting during the First World War and the result seems particularly appropriate for our requirements. The syndicate method of negotiating for, or bidding on, provincial issues has evolved into a very satisfactory method of purchase and distribution. However, ways and means could be found to improve the liaison between the investment community, the Finance Department and the Bank of Canada which could probably result in more efficient and effective marketing of new Government of Canada issues. To achieve this objective, a standing committee on the marketing of government bonds should be established by Government decree.

28. Because of the Federal Government's control of the money supply, the dangers of it relying on short issues and Savings Bonds are not as great as is the case with the Provinces. In the main, it would seem that the Provinces should issue short term securities or savings-type securities only under conditions when long term credit is not readily available. Provincial borrowing is primarily for long term projects

and long term debt should be issued against these projects. The large requirements of the provinces can only be raised by strong groups of dealers. In the case of the larger provinces national syndicates are needed to handle their requirements.

BANK OF CANADA - Appendix C

29. The recommendation of the Royal Commission on Banking and Currency in Canada under the Chairmanship of Lord MacMillan prepared the way for the establishment of the Bank of Canada and the delineation of most of its functions. It soon became evident that while the Bank should have freedom in implementing monetary policy, such policy must be in agreement with that of the Government. The unhappy events of 1961 suggest the need of a formal procedure to solve disagreements between the Government and the Bank on both fiscal and monetary policy.

30. The original Bank of Canada Act (1934) provided that the Bank was responsible for debt management, but it did not actually become the Government's agent until 1938. Since this time and particularly with the growth of the welfare state concept, debt management has tended to cause a conflict of interest for the Bank. The Bank's objectives are "to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion". Debt management has periodically hindered the Bank in carrying out these functions.

31. The placement of new Government of Canada issues is carried out by a number of different methods, normally through primary distributors including the Chartered Banks, members of the I.D.A.C. and other brokers and dealers. Most of these distributors do not normally take

positions or make markets in Government securities. We contend that consideration should be given to reducing the unwieldy list of primary distributors to those who regularly operate in this field. In some new issues, the amount being publicly offered is unknown due to Government or Bank subscription. This causes uncertainty particularly in view of the fact that such bonds may be re-offered at a later date, since the adequacy of the pricing and the judgement of the market's ability to absorb an issue depends to a large degree on the size of the issue. On occasion the Bank has acquired the entire amount of a new issue at the advertised price and subsequently sold the bonds to primary distributors at a higher price. Such techniques are undesirable in our view. To a considerable degree these unorthodox activities have been necessitated by the Government's heavy cash requirements.

32. The statistical material provided by the Bank is invaluable to business and government. More frequent publications of explanatory material would be helpful.

33. The MacMillan report emphasized that the Directors of the Bank should be men of experience, skill and integrity. Our investigation indicates that less than one-half of the man years served by the outside Directors of the Bank have been served by men whose background was related to financial business. In the future more emphasis might be laid on the selection of men with experience and skill in financial matters.

34. The Bank's most important function is to influence economic conditions by effecting changes in Chartered Bank cash positions. An important and related objective is to broaden the market for Government securities and the Bank has taken a number of forward steps to increase the liquidity of the market. A further step in the form of extending bank lending facilities to selected dealers on collateral now beyond the term of the money market might be explored.

35. Open market operations are a traditional tool of implementing Central Bank monetary policy and these operations are more effective if

the securities markets are broad and resilient (see definitions Appendix F). The Bank can effect such operations by buying more or less at weekly bill tenders as well as by operations in the securities markets. At times the Bank seems to have underestimated the psychological results of open market dealings. Since the bill sector of the market is broad and resilient it seems logical that the Bank should conduct its open market operations primarily in the short term sector of the market. In periods of crisis when disorderly markets may occur, there may be occasional need for the Bank to transact business in longer maturities.

36. In connection with Bank trading, it should be pointed out that its traders in the financial centres of Toronto and Montreal are not given sufficient authority and discretion. Also, its trading departments are understaffed. Although they will deal with all dealers some pressure is removed from Bank traders by virtue of the $250,000 minimum on Bills and bonds due within three years and a $100,000 minimum on other transactions. But consideration should be given to limiting trading of the Bank to these organizations which endeavour to make markets regularly.

37. The Bank of Canada is responsible for operating Government accounts and funds such as the Securities Investment Account, (which is used to invest surplus Government cash) and the Unemployment Insurance Fund. Operation of the latter has in the past frequently necessitated buying or selling action which was contrary to the Bank's monetary policy. Due to portfolio changes in 1961, this is no longer such an important factor. The Bank also operates The Purchase Fund for the Government. The market has been unsettled by the knowledge that securities in this and other funds might be re-offered at any time. This trading can have important affects on the banking system and also can be confused with open market operations and thus be unnecessarily disquieting to the market.

38. When the Bank purchases or sells exchange, it may contract or enlarge Chartered Bank reserves. Until recently, exchange reserves have

been sufficiently steady that the Bank's operations in the exchange market have had no significant effect on the Canadian economy. Since the declaration of the Government Exchange Policy in 1961, substantial changes in this fund have occurred. Dislocations in the exchange market have resulted. A full examination of this area of the Bank's responsibilities and operations would be desirable at this time.

39. Since 1954, the Bank has had the power of regulating the cash reserves of the Chartered Banks and since 1955 secondary reserves have been required. It would seem that the agreement that requires secondary reserves is now at best of doubtful value.

40. Traditionally changes in the discount rate signal changes in the intention of the Central Bank and touch off adjustments through the entire interest rate structure. To our knowledge, Canada is the only country where this is not true today. Because the discount rate is tied to the bill rate, changes in it have little psychological impact. While the Bank can effect moves in the discount rate by buying or selling Bills, other central banks employ both open market operations and discount rate adjustments to indicate their policies and intentions. It is suggested that the Bank return to an administered rate.

41. The Bank's monetary policies would be more effective if other institutions which accept deposits and make loans were subject to regulations equally effective to those which the Bank exercises over chartered banks. It is further suggested that the Commission consider whether powers should be given to the Bank to influence margin requirements, terms of instalment purchase, term lending by banks and cash reserves of "near" banks. The Bank's ability to deal with these sectors is at present largely dependent on its powers of moral suasion. While most of its attempts at suasion have been successful, occasionally its objectives have not been attained. Failure in this area can prove to be embarrassing.

42. Even under the most harmonious fiscal and monetary policies, actions of the Bank can never provide a perfect solution for Canada's

economic problems. It can only act in a broad and general manner to bring about an atmosphere more conducive to the attainment of desirable economic objectives. Occasionally, in the interests of orderly markets, actions must be taken which tend to controvert monetary policy. Bank effectiveness is severely limited in periods where fiscal policy must take precedence over monetary policy. The emphasis of the Canadian economy on international trade implies that deficit spending or expansionary monetary policy does not have as strong an effect as many might expect. Such policies have little influence on foreign demand for our products and indeed, in so far as they may influence costs and prices, could even reduce this demand. On the other hand, such expansionary actions are dissipated to a considerable degree by substantial portions of the increased spending power being employed to purchase imported goods. With these limitations in mind it is urgent that government return to fiscal orthodoxy as soon as possible. Cyclically balanced budgeting policy is needed to bring fiscal and monetary policies back into harmony.

MUNICIPAL FINANCE - Appendix D

43. The Canadian municipality is responsible for matters which primarily affect local residents. While education is considered a provincial responsibility, facilities and teachers are provided by the municipality. Municipalities owe their existence and authority to the provinces. The special sphere of operations of the municipality necessitates discussing its capital financing separately from provincial finance.

44. The municipality's basic sources of capital are current revenues, grants from senior governments and the proceeds from the sale of debentures. The rapid population growth since 1945 combined with the demand for higher standards of services has resulted in increasing municipal capital requirements. In some provinces, provincial corporations have been established to buy municipal debentures and in some others annual grants covering a percentage of annual service charges on debentures are provided. Such

assistance has aided municipalities in obtaining their capital requirements and in holding down their borrowing costs.

45. The traditional method for a municipality to raise capital is by selling debentures. Normally, the established municipality with a moderate capital borrowing programme will achieve good results by calling for tenders. However, a municipality with a heavy borrowing programme may be well advised to market issues through a fiscal agency group. Cities such as Ottawa, Hamilton, Vancouver and Toronto have followed this practice from time to time. Fiscal agencies may also be best suited for new municipalities and those in special circumstances or difficulties. A fiscal agency ensures that issues are properly prepared and well marketed. Sometimes calls for tenders are sent to only a small list of dealers. Such notices should be published in an official gazette so that all dealers will have an opportunity to tender. In general the bid that provides capital at the lowest cost should be accepted.

46. Municipal debentures are evaluated by comparing them with the issues of other borrowers. This comparison necessitates a lot of information and statistics. Of prime importance are information and statistics which will display the quality and diversity of assessment, the tax collection record, the weight of the debt and the debt history. Comparison is made difficult by the variety of bases of assessment and statistical information from province to province. Standardization on a nation-wide basis would be very helpful in evaluating municipal credits. In addition to the basic evaluation the investment dealer must consider such features as term, redemption clauses and coupon rates.

47. The chief markets for municipal debentures are financial institutions such as the chartered banks and trust companies which favour purchasing the shorter maturities and the insurance companies and pension funds which favour purchasing the longer maturities. Capital requirements of Canadian municipalities in 1961 were estimated at $471 million or about 46.5% of total provincial financing in that year. Since the imposition

of the 15% federal withholding tax practically all of the capital requirements have had to be raised in Canada. This has denied municipalities the advantageous rates which were being obtained on external borrowings and tended to increase borrowing costs. Consideration should be given to rescinding this withholding tax.

48. Marketing of issues would be assisted if municipalities would refrain from offering true serials which result in odd principal amounts that are difficult to sell. In general, serials are difficult to sell to the public because there are so many different maturities. It would broaden the market if municipal issues had serial maturities in the early years designed for sale to the banks and others, and a long term sinking fund maturity to satisfy the requirements of other institutions and the public. Sinking funds would create some demand for outstanding debentures and assist in making a market. The market for municipal issues would also be improved, if the Department of Insurance were to permit insurance companies to evaluate their holdings at the amortized book values as is the practice for federal and provincial obligations. Also, school debentures should be made eligible for deposit by non-resident insurance companies. In our opinion the issuance of tax exempt debentures in Canada would not result in a substantial improvement in the market or in significantly lower debt service charges.

49. The provinces have been increasing their assistance to municipalities. A simple but effective form of assistance is to require municipalities to provide the provinces concerned with information about their history and economic and financial condition. The provinces then distribute the information to dealers and very often incorporate it in tender notices. Another effective method of assistance is for the province to remit certain grants to the paying agents for the debentures so that these grants may be used directly in servicing the debt. This procedure has resulted in lower borrowing costs for the municipality. The market for municipal debentures has been assisted by purchase of parts of issues by various provincial accounts, but probably the most effective form of marketing assistance is the provincial guarantee of principal and interest payments. This is undoubtedly of major importance in marketing of issues of little known or low rated municipalities and school boards.

Corporation Finance

50. During the 10 years, 1949 - 1959, the number of companies tabulated by the Department of National Revenue rose from 35,706 to 86,996 and their assets from $21 billion to $63 billion. There are several assumptions which should be kept in mind in using these statistics but subject to these, 38% of the application of funds of these companies over the period was derived from long term debt and equity issues. For the capitalization of the finance and utility segments of this group debt is a higher proportion of the total. In the manufacturing sector 60% of the funds were generated internally, 12% from the issuance of debt, 14.5% from equities and 13.5% from other sources. Over the 10 year period this tabulation showed capital expenditures of $11 billion with capital cost allowances contributing $6.7 billion or about 60%. Reflecting this large contribution of internally generated funds, the working capital ratio of the group declined only slightly from 3:1 in 1949 to 2.7:1 in 1959. The percentage of debt in the capitalization increased from 12% to 17%. The trend towards higher proportion of debt in the capital structure was particularly evident in the case of smaller companies where there is a strong desire not to dilute ownership and to achieve leverage. Smaller firms also showed a noticeably higher proportion of bank borrowings in their capital structures.

51. It is important to note that the cost of issuing debt in the postwar period has been lower than the cost of raising funds through issue of preferred and common shares. A rising corporation tax rate is responsible for this and the higher this rate the greater is the cost differential. At today's rate a company can afford to pay an interest rate of 8% before the net cost exceeds a dividend rate of 4%. At a 40% corporate tax rate the interest-rate-equivalent of 4% dividend would be reduced to 6.7%. The pronounced tendency of corporate income tax rates to creep upward provides positive incentive for unsound corporate financing. The financial structure of companies varies according to size. Small companies tend to have more recourse to bank and mortgage financing and to retain a higher proportion of profits. These differences reflect the ease with which large companies can obtain funds in the market.

52. Data published by the Bank of Canada on new issues of securities from 1949 - 1960 shows a total of $8.8 billion being raised, of which $5.2 billion was debt, $.6 billion preferred, and $3.0 billion common. Rights issues of the chartered banks and the Bell Telephone accounted for 28% of the total new issues of common stocks. The proportion represented by debt varied from year to year but in the 1949 - 1956 period was 56.3% and for the 1959 - 1960 period 59.5% of the total. During the period of this survey a number of new large companies were formed, notably natural gas utilities and finance companies and some large firms were absorbed by others, notably in the pulp and paper industry. Thus, the total number of public companies did not increase very substantially. Indeed, between the end of 1948 and the end of 1961, the number of stocks listed on the T.S.E. increased only from 867 to 1,117 with most of the increase being in the junior mining and petroleum group.

53. A detailed description of the underwriting process in Canada is provided in Appendix E Paragraphs 17 to 34. In addition, the dealer often acts as agent for the issuer in privately placing securities with institutions. Lower commissions are charged for private placements as the expenses and risks are much lower. Occasionally, small issues are underwritten on a "best efforts" basis with the dealer receiving a straight commission on the sales made. A major underwriter has the responsibility of providing sound advice on the best terms and lowest overall costs of an issue. He must also provide the placement power to sell the issue, and, in doing this, must correctly represent to his clients the quality of the issue and the degree of risk.

54. A study of the distribution of holdings of corporate and other non-Government bonds indicates that domestic institutions and pension funds provide the largest market. Among this group the life insurance industry is the most important buyer. In 1954 this industry held approximately 35% of the outstanding total amount of these bonds but by 1959 this had declined to 29%. This trend indicates that problems of distribution are becoming more complex and that the investment dealer is having to develop other markets.

55. The cost of issuing securities varies with the size of the issue and the degree of risk. Legal fees, prospectus preparation and production, research and sales expenses are more or less fixed regardless of the size of an issue. Risks are greater on securities of small or new companies. Both

the risk and expense factors mean higher costs on small issues. Comparison of figures in tables 4 and 5 (Appendix E) which show Canadian and S.E.C. data, indicate that underwriting cost of small issues under $3 million are lower in Canada than in the U.S. and somewhat higher on issues over this amount. A Moody's study of U.S. utility issues shows spreads of from .10% to .17% while issues of Canadian utilities with similar ratings showed spreads ranging from .11% to .17%. Despite these similarities there are fundamental differences between the two markets. The size of the financial institutions in the U.S. is such that large issues can be sold to a small number of buyers, whereas in Canada most issues are sold to a large number of institutions and individuals. This means that costs of distribution are significantly higher in Canada.

56. Utilities in the U.S. are required to call for competitive bids, whereas in Canada the practice is to have negotiated issues. In theory competitive bidding might be expected to produce the most favourable prices but there is reason to believe that this may not be true. In a survey of 16 comparable pairs of issues, 11 of the comparisons showed a yield to the public and yield cost to the company to be lower for negotiated sales. The fiscal agent maintains a continuous relationship to the Company and is in a position to assist in determining the timing and terms of an issue. He can also test the market ahead of time which is a distinct advantage. In competitive bidding dealers are required to bid on short notice without the benefit of advanced preparation and full and detailed knowledge of the Company's position and therefore, they tend to allow for unforeseen contingencies. On this subject Judge Medina has commented that the advantages to an issuer of a continuing relationship with a good investment banker are obvious.

57. Canadian companies either gradually write off expenses and discounts on issues, or charge them at once to earned surplus. These charges are not deductible for income tax purposes. To the extent that these charges represent underwriters' commission we feel strongly that they should be a deductible item as they are a cost of raising funds.

Legislation

58. Securities legislation in Canada involves 10 provincial securities acts, various provincial companies acts, the Companies Act of Canada, the Ontario Corporations Information Act and the Quebec Companies Information Act.

There has been a movement toward achieving uniformity in this mass of legislation which movement has been encouraged and endorsed by the IDAC. The provinces are currently studying a uniform Companies Act and 4 provinces now have identical or nearly identical securities acts. There would seem to be large advantages to the investing public and the investment industry in enacting uniform securities legislation and administering it in a uniform manner. In the U.S. there are two Federal acts and in addition 48 states also have securities legislation. It would seem likely that if SEC-type legislation were established in Canada it would not replace existing provincial statutes but would be superimposed on these. The Association believes that such superimposition would not be in the best interests of our capital market.

59. It would seem desirable that the various securities acts should permit the production and distribution of a preliminary prospectus in Canada as is the practice in the United States. This would permit more orderly marketing of new issues and give security purchasers more time in which to study them. It would also be helpful if all regulations affecting the underwriting and sale of securities were promulgated to the I.D.A.C.

60. The I.D.A.C. has strongly asserted that in the interests of justice provision should be made for arbitration and independent appraisal by provincial governments desiring to expropriate electric utilities. It would seem desirable that the temptation to expropriate arising out of the Federal tax treatment of the provinces should be removed. Also, certain mergers and amalgamations may be beneficial to Canada but the I.D.A.C. deplores certain recently employed "take-over" techniques.

61. A company incorporated under the Companies Act of Canada is a natural vehicle to carry on business in several provinces. However, this Act contains several anomalies which tend to deter incorporation and to create unnecessary delays and expenses. This Act should be reviewed with a view to eliminating these anomalies.

THE SECONDARY BOND MARKET - Appendix F

62. Through the secondary market, previously issued securities are transferred from one investor to another. Those normally participating in this market are Bank of Canada, chartered banks, Members of the I.D.A.C. and a number of other brokers and dealers.

63. The secondary market is large and active and absolutely vital in providing a mechanism for investment and dis-investment. In 1961 the volume of sales of I.D.A.C. members, exclusive of primary market sales, was $15.9 billion and their average quarterly inventories were $377.6 million (see table 1 appendix F). This active market ensures liquidity and establishes a spectrum of values. The substantial difference between mortgage and bond rates is primarily the result of the liquidity provided by the secondary bond market. The breadth of this market also greatly facilitates the open-market operations of the Bank of Canada and the dealings of the various Government accounts.

64. Up to 1917, the markets for Canadian debt securities were concentrated in London and New York. The large Government financing of the First World War and the corporate financing of the 1920's necessitated and encouraged the growth of a highly developed secondary bond market.

65. The Trading Departments of many dealers are regarded as the nerve centres of their operations. Vast networks of private wires, telephones and other public services are utilized to maintain contact with, and to trade in, national and international markets. These networks enable the industry to give adequate service from coast to coast and literally to draw upon the savings of the nation.

66. A number of dealers customarily act as principals and their willingness to assume liabilities in accordance with future trends of the market, as they judge it, does much to moderate market swings. The positions they take also permit trading in the size required by insurance companies, banks and other institutions. Some 30 to 40 dealers make markets in the vast majority of the securities traded, do the bulk of the trade and carry most of the inventory. These are the dealers to whom

financial institutions, the Bank of Canada and other dealers look for prices, bids and offerings. The ability of these dealers to provide trading services would be improved if a larger number of financial institutions made a practice of lending bonds at reasonable rates.

67. Secondary market trading in debt securities has not attracted restrictive legislation as the industry has demonstrated its competence in self regulation. This is primarily due to the regulation provided by the I.D.A.C. and Bond Traders' Associations, which is described in detail in Appendix A part 1. The occasional misunderstandings and difficulties which have occurred have been dealt with quickly and responsibly by the industry's regulatory bodies.

68. The secondary bond market is customarily divided into two categories, one being the money market which is dealt with in Appendix G and the other consisting of all other securities, principally those maturing beyond three years. It is important that a broad and resilient market exist at all times for Government of Canada medium and long term bonds because these bonds provide the bench mark from which all other securities are graded. Investors look to the market for Government of Canada bonds for stability, quality and marketability. However, except for artificial support provided by the Government the long term Canada market has not had depth in recent times. For Provincial issues, the market tends to be narrower although the large issues of Ontario and Quebec receive broad public interest. In general, municipal bonds have limited secondary markets, and, except for the largest corporations, the supply of corporate bonds usually dries up shortly after new issues. The narrow spreads between bid and asked prices result from the keen competition between dealers and provides all investors with access to fair prices.

69. A characteristic of a growing economy is the large demand for funds in relation to the supply. The U.S. market is now the major source of foreign funds. It is therefore necessary for Canadian interest rates to be higher than comparable U.S. rates if funds are to be attracted to Canada.

70. The most significant domestic factors affecting interest rate trends in Canada, are the Federal Government's fiscal policy and the monetary policy of Bank of Canada. A fiscal policy, even on a long term cyclical basis, of balancing deficits with surpluses would provide a strong underpinning to the whole bond market. The recent policy of utilizing Canada Savings Bonds as a prime method of financing has tended to reduce the number of private investors buying bonds without redemption privileges. This is adversely affecting the breadth of the long term bond market.

71. Policies which will increase confidence in Federal Government securities are of major importance in stabilizing markets and in the long run, in improving the general functioning of the economy. Such policies include: determined effort to balance the budget and re-examination of the tax structure. The establishment of a specific month for the Budget Address and regular reports on the Government's financial policies would remove some of the uncertainties from the market.

72. In the monetary field, practices which indicate clearly the direction of monetary policy, such as the return to a stated rediscount rate, should be considered. Uncertainty could be reduced by more rapid replies to dealer bids and offerings by Bank of Canada. This institution is the most important single influence in the market and its actions should be quick and decisive. It might be desirable to remove portfolio dealings for Government accounts from Bank of Canada jurisdiction and also to have the Bank play a lesser part in the subscription for new issues. Actions by Bank of Canada should reflect monetary policy not agency trading. Thus, through modifying its trading practices and through regular policy explanations, the Bank could better guide the market.

73. The last section of Appendix F deals with the advantages and

disadvantages of a bond exchange and concludes that the present dealer market provides investors with the most efficient service at the lowest cost.

"SHORT-TERM MONEY MARKET" - Appendix G

74. The money market, which began in 1954 when thirteen dealers were granted lines of credit has grown substantially since that time. This growth can be seen in the variety of borrowers presently competing for the available short-term funds and in the tremendous growth in volume since that time. This competition for credit and the rates offered have attracted many who had previously left them lying dormant for short periods of time to invest their short-term funds in the money market. The relatively high short-term interest rates which occurred in 1959 did much to make investors aware of the substantial rewards of making their cash work at all times.

75. An increasing number of borrowers are raising part of their capital requirements in the short-term market. The Federal Government, since the Conversion Loan of 1958, has raised nearly all of its cash in the money market. The longer maturities issued by the government (excluding C.N.R.'s) during this time were all, with the exception of one issue, sold to the Bank of Canada for resale to the public.

76. Provincial and municipal governments have also found that the money market will provide them with additional sources of funds at a relatively low cost, while often allowing them to choose the most favourable time for financing in the long-term market. Finance companies regularly borrowed a considerable part of their requirements in the short-term market, but over the past five years, corporations have also become active sellers of paper. Because of these developments in the money market, the chartered banks and trust companies have been forced to become more aggressive in retaining deposits and in attracting new deposits.

77. At the present time, few statistics relating to the money market are collected and made available to the public. The Bank of Canada publishes the amount outstanding and distribution of treasury bills and short-term government bonds two years and under. The Dominion Bureau of Statistics supplies information relating to the short-term borrowings made directly by the provinces. However, there is no information available as to the amount of municipal borrowing in the money market or of the amount of corporate paper issued and outstanding. It is recommended that more detailed statistics be kept relating to all sectors of the money market. Appendix G examines in some detail the amounts of various short-term obligations presently outstanding in the market, i.e., (a) treasury bills, (b) Government of Canada and Guaranteed bonds maturing within three years, (c) provincial and municipal short-term obligations, (d) sales finance company paper, (e) corporate paper, (f) deposits accepted by the banks and trust companies.

78. The Floating Bank Rate, calculated weekly at 1/4 of 1% above the average rate paid for 91-day Treasury Bills, plays a practical and stabilizing role in the money market. The variable Bank Rate has encouraged the money market dealers to carry an inventory of government securities during periods of cash adjustment in the banking system, when day-loan facilities are not available. If the Bank of Canada returns to a traditional Bank Rate, it is recommended that a "Bank Accommodation Rate" or "Bank Lending Rate" be made available by the Bank of Canada to the money market dealers on a formula similar to the present Floating Bank Rate.

79. The money market dealers have developed an efficient market capable of transferring large amounts of short-term securities at narrow price spreads, and the initial problem of two financial centres in Toronto and Montreal has been largely overcome. However, the Bank of Canada's trading departments in Toronto and Montreal, which are the Bank of Canada's contacts with the market, are not mechanically equipped nor staffed to handle the practical problems relating to the money market.

The dealer at present frequently finds it difficult to contact the Bank of Canada quickly and receive immediate answers. These problems could be largely overcome if the Bank of Canada's traders had direct keys to the money market dealers and Chartered Banks. It would also help if there was one trader in each of the two cities who concentrated on money market securities and had time to acquaint himself with all the factors influencing the money market rates.

80. The increasing role of the "country banks" in financing dealer inventory is an important development in broadening the money market. The I.D.A. obtains statistics weekly from its members relating to the amount of inventory financed away from the chartered banks. This information is made available to the members of the Association, Bank of Canada and the Department of Finance.

81. At times, when the short-term rate differential between the United States and Canada is attractive to the non-resident, considerable funds flow into the Canadian money market. Since the introduction of the 15% withholding tax on treasury bills on December 20, 1960, these flows have been directed towards the purchase of Canadian finance company and corporate paper. Canadian short-term investors will themselves place funds in the United States or abroad when rates are attractive. The question of withholding taxes on money market securities is dealt with in Appendix G. It should be pointed out that nearly all non-resident short-term investments are fully hedged. However, this is a factor influencing Canadian foreign exchange rates and, at times, money market rates, themselves, in Canada.

82. Our well-developed money market is contributing substantially to Canada's economic growth and the investment dealer organization has expanded to keep pace.

CHARTERED BANKS AND "NEAR BANKS" - Appendix H

83. The relationships between the investment dealer and the chartered banks and "Near Banks" are discussed in appendix H. "Near banks" are defined as all institutions other than banks which receive deposits or make loans.

84. The nature of the investment business is such as to require continuous large scale accommodation from these institutions by way of call loans and day loans. Such loans are of high quality. During certain periods and particularly during the period from August 10, 1959 to October 11, 1960, chartered bank rates on such loans remained unacceptably rigid. Due to this lack of flexibility, dealers turned to "Near Banks" for accommodation. This development arose purely out of the need for a more competitive "price" on the large borrowings of this industry. We believe that the inflexibility of bank rates is in part caused by the 6% ceiling. This ceiling does not apply to "Near Banks". It is recommended that the 6% limitation be removed to permit the chartered banks more freedom to use a "price" basis as a deterrent to undesirable loan expansion.

85. Investment dealers use the facilities of banks extensively for deliveries and the like. Co-operation between the I.D.A.C. and the C.B.A. through the establishment of a joint committee would smooth out imperfections in this area.

86. Banks are the custodians of the bulk of the personal savings deposits of millions of Canadians. The bulk of bank security holdings mature within a five-year period and tend to be regarded as the temporary utilization of idle resources. Thus these holdings are very volatile, falling as commercial loans expand and rising as commercial loans decline. The possibility that personal savings deposits might be applied to a greater degree to long term security holdings and thus make a greater contribution to the economic growth of Canada should be explored.

87. The chartered banks through term deposit receipts are important issuers of securities. In our opinion rate changes on these securities have not been as responsive to changes in market conditions as is desirable.

88. Chartered banks compete with dealers in the underwriting and

distribution of securities. They are offered Government of Canada new issues on the same terms as are dealers. One or more banks are part of most syndicates bidding on new provincial issues. The judgement of the bank in this area carries special weight because it may also be a financial advisor to the Province. Banks are frequently members of syndicates bidding for Municipal issues, and, in the case of serials, often agree to purchase the early maturities. A bank's interest in the "shorts" has an important effect on the price the syndicate is willing and able to pay. In corporate issues bank participation is infrequent. However, there are a few important exceptions.

89. Considerable disagreement exists amongst our members as to whether bank participation in syndicates is in the public interest or serves any useful purpose. Some members believe that banks have a generally salutory effect by sharing the risks, providing accommodation, and by adding strength to the bids by buying for their own account portions of the issue. Others point out that undesirable conflicts of interest may arise as a result of bank participation and suggest that the primary function of banks is and should continue to be the provision of short term accommodation for their customers. The majority of our members do agree that involvement of banks in syndicates underwriting corporate securities should not be extended. It should be recognized that satisfactory performance of underwriting function is one of the principal contributions the investment dealer has to offer to the proper functioning of the whole capital market.

90. In distributing securities, banks enjoy advantages resulting from their widespread branch systems and special knowledge of customer resources. They have been a significant factor in the distribution of Canada Savings Bonds which we might point out involves no risk and is done at only incidental cost. Banks participate in selling groups on the same basis as dealers. The effectiveness of banks in distributing securities in small communities largely beyond the reach of investment dealers is acknowledged. However, important conflicts of interest can occur and at times individual bank managers may be inclined to discourage investment in order to maintain savings deposits. At such times as the banks are sellers of securities to

meet expanding demands for loans it is particularly important that dealers have a strong sales force to handle the essential function of distribution.

91. As a result of the inadequacy and cost of chartered bank accommodation at various times, dealers have developed "near banks" as a source of funds. These institutions also provide funds for other financial intermediaries. They also issue a variety of securities. The size and importance of these institutions has grown in recent years and they have a significant impact on the market place.

RETAILING BONDS AND STOCKS and RISK CAPITAL - Appendix I

Retailing Bonds and Stocks

92. Bond sales up to the 1st World War were made primarily in foreign markets with domestic sales being confined to financial institutions and wealthy individuals. The Victory Loan issues of the War carried high interest rates and tax advantages which encouraged individual investment. During the 1920 - 1930 period almost $6 billion was invested in capital goods and the proportion of foreign capital drawn upon was considerably reduced. In this period, individuals participated in the security markets in an increasingly broad and active manner. The wide acceptance of the Victory Bonds of the 2nd World War was a result of educating a large selling force. In this period, the Payroll Savings Plan was developed. The Victory Loan campaigns of World War II were responsible for millions of Canadians owning investment securities for the first time. Today there are over two million individuals in Canada who own Government of Canada bonds. These citizens are a stabilizing and supporting factor in the bond market. Continuation of the habit of thrift developed during the war is maintained by an annual Canadian Savings Bond campaigns.

93. The small investor, whom we shall define as having up to $10,000 invested in securities, does not normally have much knowledge of securities markets. His investments are usually either exceedingly conservative or extremely speculative. The small size of his holdings severely restricts the degree of diversification he can achieve. The small investor is likely to be a good market for bonds but is unlikely to be a good source of capital

for sound new enterprises. The investment dealer solicits his business and spends much time educating and assisting him.

94. The medium investor is an individual with between say $10,000 and $100,000 invested in securities. Quite often he is a professional or business man whose income is substantial and growing. On the other hand, the medium investor may be a retired person, a widow or a dependent who has inherited capital. Generally, this class of investor will be moderately well-informed but will tend to rely heavily on the advice of the investment dealer. The professional or business man is often in a high income tax bracket and therefore interested in capital appreciation. Much of the educational effort of investment dealers and the I.D.A.C. is aimed at the medium investor.

95. The large investor who has securities investments of $100,000 or more will normally be quite well informed. The cost of doing business with the large investor, relative to the return, is substantially below that with other groups. He provides a good market for all types of securities including stocks in risk ventures.

96. Investment dealers service the retail market by sending salesmen into the field. This is not true of banks and stock brokers. To service retail accounts it is of primary importance that the dealer have the knowledge and resources to study and underwrite the securities to be offered. He must also have a force of qualified salesmen, facilities to train these salesmen and capital to carry them until they become productive. The trainee will usually spend time in each of the operating departments, attend sales meetings, and complete at least one of the courses offered by the I.D.A.C. The dealer also requires a research department to supply salesmen with information and guidance, accounting and trading departments and a communications system. He may also engage in portfolio supervision and underwriting. Through the I.D.A.C. as well as through a broad variety of material he may produce himself, the dealer contributes to the education of the investing public. Provision of all these services means that the cost of doing retail business is high.

97. The dealer must acquire clients to expand his business. Most new investors come to dealers through referrals but, in addition, the dealer attracts them through advertising and through approaching them directly. However, in some provinces there are legal restrictions regarding approaching prospective clients at home except to sell Government Bonds and this can have the effect of somewhat restricting the development of new accounts.

98. It would be helpful if the Government of Canada would give more consideration to the retail market when establishing the terms of new bond issues. Such consideration would provide a strong incentive to broadening the market for Government and other securities in Canada.

Risk Capital

99. All types and variations of securities issued for the development of new ventures must be defined as risk capital. Basically, there are two types of risk capital - that for long term investment in intelligent and seriously conceived new ventures, and that for short term investment in risky securities where quick profits are sought with little concern for the ultimate outlook of the enterprise. Many retail investors who do take an interest in well conceived ventures are inclined to ignore the ultimate potential and accept short term capital gains, if and when available. Thus, the equity in these ventures tends to shift from the public to institutions and foreign investors. On the other hand, the public will hold for long periods the securities of such enterprises as established utilities. Dealers are continually attempting to educate and interest individual investors in the long term development of new enterprises. Participation in such developments could be broadened if the shares of an institution such as the Industrial Development Bank were offered publicly. It is recommended that tax advantages be provided to encourage individual investment in risk ventures.

100. Raising long term risk capital is difficult. The investment dealer must do a great deal of work, sometimes on many companies, before he finds one of the size and promise suitable for public offering. Then he

must, through sales meetings, field trips and the like, introduce this Company to his sales force. This is an expensive and time-consuming process. In order to protect clients, the underwriter must continue to take an interest in and make markets for the securities he has distributed. Where difficult conditions develop, the dealer will endeavour to protect his clients' capital by devoting a considerable amount of time, and sometimes his own capital, to the restoration of the enterprise to profitable operation.

STOCK BUSINESS - Appendix J

101. The stock business in Canada is largely carried on through the five stock exchanges, with the Toronto Stock Exchange and the Montreal Stock Exchange handling the vast majority of the business. These two exchanges listed a total of about 1,250 stocks at the end of 1961, at a quoted market value of close to $62 billion. Of this market value, about $31¾ billion consisted of stocks of foreign firms, mainly large United States companies. Excluding these foreign stocks, trading activity in 1961 represented about 8.6% of the quoted market value of the Toronto Exchange. If adjustment is also made for that portion of the stocks which are closely held, trading activity would have represented about 12.3 % of the supply available to the market. In recent years there has been a growing number of secondary distributions of large blocks of stock.

102. Stock trading is done on an agency basis with commission rates as set by the exchanges being charged for buying and selling. Commission rates were revised upward in 1945 and subsequent to this, changes have been primarily modest upward revisions and reclassifications. Demands for added services in the post-war period have been such that the cost of consummating stock business has risen rapidly.

103. A large over-the-counter market exists in Canada but the main volume of trading in this market consists of bonds and debentures, which are dealt with in appendix F. The stocks traded in the over-the-counter market are primarily those of natural resource and specialty companies. A large number of dealers operate in this market, but except in periods of active development of new industries, such as uranium, over-the-counter activity is very small compared with that in the United States.

104. The supply of stocks available to the investor through new issues has been strongly influenced in the post-war period by the large proportion of capital expenditures which business has financed internally; foreign financing; the lack of certain growth industries in Canada, such as electronics; the growth of foreign-owned subsidiaries in Canada; expropriation of utilities by Governments; mutualization of insurance companies; increases in the corporate tax rate which provide incentives for debt financing and by inflation, which also provides incentive for debt financing. In recent years only about two fifths of the new capital raised by corporations has come from equity financing. On the other hand, the supply of new stock issued has undoubtedly been increased by the 1954 revision of the Bank Act, which assisted the banks in making rights offerings; the limited financial strength of certain companies which necessitates equity financing and by the need of utilities and other companies to maintain their equity bases.

105. The demand for stocks can be broadly divided into that arising from individual investors and that from various institutions. There is considerable overlapping however because some institutional demand, such as that of the mutual funds, arises directly from individual investment. In 1959, just over 9% of Canadian families and unattached individuals owned stocks, with the primary incidence being in the higher income brackets. A United States survey in June 1955 indicated that 8% of United States family units were stockholders. Thus the incidence of individual stock ownership is probably very similar as between Canada and the United States.

106. The information available on institutional stockholdings varies widely from one institutional group to another. In 1960, life insurance companies held only about 2.2% of their assets in preferred and common shares although the statutory limits permit 15%. A large portion of the stocks held were foreign and at December 31st, 1960, only .96% of their assets were represented by Canadian common stocks.

107. Fire and casualty companies, on the other hand, hold 7.2% of their assets in Canadian and foreign common and preferred shares, a considerably higher portion than most other institutions.

108. Trust companies represent a very important sector of the demand for stocks. Of their assets, approximately 2.9% was invested in preferred and common stocks at the end of 1960. However, 85% of trust company funds are administered funds and on a large segment of these there is no published information. It can be assumed that a significant proportion of these administered funds are invested in equities. In this connection, it is interesting to note that in 1959 the personal trust accounts in United States banks and trust companies were over 70% invested in equities.

109. Mortgage and loan companies, at the end of 1960, showed the book value of common and preferred holdings at 5.1% of their total assets.

110. Pension funds provide a well-documented area of institutional investment. The asset distribution of the plans of incorporated companies show that equity holdings grew from $53 million in 1952, or 7.4% of assets, to $239 million in 1960, or 12.3% of assets. These industry plans made up about three fifths of total trusteed pension plans. Their emphasis on equities is as striking as is the lack of such emphasis in the investments of crown corporations and Government agency pension funds. In 1960, the holdings of all trusteed pension plans represented approximately 1.16% of the value of all listed common stocks. It is estimated that the amount of common stock investments of all trusteed pension funds was $50 million in 1960, or about 12% of net funds available for investment.

111. Investment companies of the open-end type are easily the most important source of demand for equities. Their net flow of funds into equities in 1959 is estimated at $80 million. At the end of 1959, the market value of Canadian stocks held by these companies totalled $472 million and represented about 2.28% of the value of Canadian common stocks listed at that time.

112. In the post-war period, the investment by non-residents and non-resident institutions has had a very important impact on the demand for equities. At the end of 1958 the book value of the capital stock

of Canadian companies, owned by non-residents, amounted to $9.3 billion, of which $6.8 billion represented direct investments. It is estimated that non-resident trading accounted for about one-fifth of the value of the shares traded on Canadian exchanges in 1959.

113. In the 1955-1959 period, N.R.O. funds and other foreign-owned portfolio purchasers acquired $887 million in Canadian securities. During the post-war period, there was a steady rise in foreign interests in manufacturing, oil, natural gas and mining and smelting and a steady decline in the interests of foreign investors in railroads and utilities. The direct foreign investment has been based primarily on a desire to gain access to the Canadian market, access to the Commonwealth market or access to natural resources, the latter often being associated with vertical integration. It is probable that without massive foreign participation, many of the developments so financed would never have taken place. In terms of technology, the contribution of non-residents is unquestioned.

114. It is important to observe that institutional holdings of stocks are heavily concentrated in a short list of well-known companies. While institutional demand has been rising sharply in recent years, particularly from investment companies and pension funds, in general, Canadian institutions apply a smaller percentage of their assets to equities than do their American counterparts. While individual holdings of equities appear to be similar in Canada and the United States it is clear that Canadians' indirect participation in the stock market through various financial intermediaries is weak in comparison with the experience in the U.S.

115. The role of investment management has become increasingly important in the Canadian economy since World War II. Both individual and institutional investors have become more knowledgeable and more demanding and investment dealers have experienced consistent pressures to provide more information and sophisticated analysis. The investment dealer has responded to the demands of growing numbers of university-trained analysts in institutions by expansion of his research department and to the demands of individuals by expanding portfolio management and advisory

services. It is estimated that it requires 4-6 years to develop a university graduate to the status of a recognized analyst at a cost of some $40,000 - $50,000. This, in addition to the growing need for information services and communications, has greatly increased the cost of doing business.

116. Improvements in the quantity and quality of the services offered, have been hampered to a considerable degree, by the difficulty of obtaining detailed and regular information from Canadian corporations. In recent years, fortunately, many companies have become more public and investor relations conscious. There has been a noticeable improvement in the quality of annual reports and an increase in the number of companies issuing quarterly and semi-annual reports. For some companies and industries, further improvements are still needed.

117. The rise of investment clubs in Canada in the post-war period has been significant in developing public interest in stock ownership. These clubs provide an opportunity for members jointly to study securities, thus broadening their investment knowledge as well as providing a means of investing personal savings. Investment clubs do not yet have a great impact on the market and the smaller ones often deal in odd lots, which transactions are unprofitable to the broker. Nevertheless, investment dealers have encouraged them because of the contributions they are making to broadening the market for securities. In this area, as in the area of its co-operation with the various stock exchanges, the Investment Dealers' Association has played an important role in encouraging public interest in equities.

MUTUAL FUNDS - Appendix K

118. Mutual funds, whose antecedents are the investment trusts of Great Britain, really began to develop on this continent in 1924 with the formation of Massachusetts Investors Trust and State Street Investment Corporation, the first of the open end investment companies. Between 1927 and 1930, over 700 investment trusts and holding companies were formed in

the United States, nearly all of which were of the closed end type. Many of these concerns were highly leveraged and there was much pyramiding of one investment company into another with the result that many more or less collapsed in the 1929 stock market crash and the ensuing depression years of the 1930's.

119. In Canada, 49 investment companies, practically all of the closed end type, were in operation at the end of 1929 and had assets of some $265 million. While there were varying degrees of leverage there was very limited pyramiding with the result that the Canadian trusts were not as hard hit as their American counterparts in the 1929 panic. Most of them won through and are in operation today.

120. Nevertheless, Canadian investors lost heavily on the "investment trusts" and confidence in such organizations died. Management, as applied to investments, was at a big discount and the public wanted no part of it. Inherently, however, the individual of more modest means still sought ways of investing to provide a combination of diversification, ready marketability, and, equally important, ways of establishing the proper market for his commitment - a feature that had been conspicuously absent from the closed end trusts.

121. Investor confidence in investment companies, however, was slow in returning. The first open end type of mutual fund in Canada was established in 1932, but it was not until 1950 that a strong investor preference for this type of fund began to appear. The last ten years have seen a rapid growth in the number and size of mutual funds. There are now 41 mutual funds of significant size in Canada of which 24 are Canadian owned, and hold essentially Canadian securities, four are primarily Canadian owned, but specialize in foreign securities, three are owned primarily abroad, but with Canadian investments, and ten are non-resident owned (N.R.O.) companies investing in Canadian stocks. At the end of 1960 the total net assets of these funds was $900 million and at the end of 1961 was estimated to be about $1 billion. During the past ten years closed end type funds have been comparatively static while mutual funds have developed into an increasingly important

position in Canadian financial markets.

122. A typical mutual fund has a simple capital structure consisting of redeemable special shares and a small number of deferred shares. The latter are held by the management group. Both classes of stock have equal voting rights. The special shares, which are redeemable at the holder's option, are sold to the public at the net asset value which is calculated daily, plus a loading charge of 8%. Normally the load is reduced to 5% for purchase of over $50,000. The bulk of this charge is paid to the investment dealer or to the sales force of the underwriter. A typical fund would be prohibited from borrowing money, buying securities on margin or selling short. Its investments would consist of about 70 common stocks of well-known Canadian companies and about 15% of its portfolio would be in preferred stocks and corporate bonds. A typical company would pay dividends quarterly but would provide means for reinvesting the dividends in the special shares of the fund. It would be managed by a management organization which would provide office space, administrative and research staff and portfolio management services. The management fee would be one-half of one percent of the average net asset value. Provisions would be made to ensure arm's length dealing by the management.

123. Mutual funds are subject to Section 69 of the Income Tax Act and N.R.O. funds to Section 70. Section 69 provides that investment companies pay a tax of 21% of their taxable income providing they meet certain requirements, namely having at least 80% of their property in, and 95% of their income from, securities or cash. At least 85% of their gross revenue must come from Canadian sources and not more than 25% from interest. The fund must distribute in each year at least 85% of taxable income. Not more than 10% of assets may be in the securities of one corporation. In addition, it must have at least 50 shareholders, none of whom own more than 25% of the shares. The N.R.O. company, under Section 70, is subject to a 15% tax if at least 95% of its shares are held by non-residents; if not less than 90%

of its gross revenues are from interest or dividends; and if no revenue is derived from business activities such as purchasing, merchandising, manufacturing and the like.

124. Mutual fund shares are normally offered for sale at their net asset value plus a fee or loading charge. A few funds have a low loading and exact a fee when shares are presented for redemption, but most funds charge about 8% on sales price and no fee for redemption. Thus the loading covers both sale and purchase. If the spread between bid and asked prices of stocks traded on exchanges and the minimum commissions which stock exchange numbers must charge on small lots are taken into consideration, loading charges do not appear to be excessive.

125. Mutual fund shares are offered for sale through the fund management's own sales staff, through investment dealers and through separate organizations having their own sales staffs which are entirely independent of the fund management. The shares may be purchased as individual transactions and through purchase plans under which a stated amount of money is invested at regular intervals. The latter may be on a voluntary or a contractual basis. Under the contractual plans some mutual funds concentrate a considerable part of the total load of the entire contract into the initial years of the plan with the result that if the purchaser terminates the contract in the earlier years of its life he may only recover part of the amount paid in. The great majority of regular purchase plans are used by small investors who contribute from $15 to $100 per month.

126. In 1957 the Income Tax Act was amended to permit the self-employed person to contribute to an individual retirement plan. Mutual fund shares qualify as media for such plans and this feature has provided a new and increasing outlet for their sales.

127. A number of funds provide "withdrawal plans" whereby a shareholder may liquidate a portion of his previously acquired block of shares at regular intervals. This process is not in any way the equivalent of the payment of an annuity and the shareholder has no guarantee that his capital will not be

exhausted. While market experience over the past 11 years has been favourable to most of these plans, there can be no assurance or guarantee that this experience will repeat itself. For the unsophisticated, the plan can appear complicated and, unless explained by a highly experienced salesman, misunderstandings could occur.

128. The growth of mutual funds may be regarded as part of a broad trend toward equity investment by the public. Investment companies are media through which the small investor can share in the risks and rewards of equity investment while obtaining professional management, broad diversification and liquidity. That investors consider mutual funds attractive is illustrated by the growth of five representative Canadian funds which had assets of $50 million in 1950 and $555.5 million in 1961. (See Appendix K, Exhibit D.) It is obvious that these funds have tended to promote individual saving and encourage investment in equities. Also, these funds have tended to make the small individual investor more conservative in the sense that they have attracted his interest away from highly speculative commitments.

129. In Canada there is no special regulatory legislation for investment companies although all mutual funds are subject to the federal or provincial acts under which they are incorporated as well as to the securities acts of the provinces in which they sell their shares. Mutual funds in Canada have to date voluntarily set high standards of self-regulation. Nevertheless, an examination of these acts should be made to ensure that these provide adequate safeguards for the investing public in both open and closed end investment trusts.

FINANCING SMALL BUSINESS - Appendix L

130. Generally a worthwhile project requiring $500,000 or more can be financed with a debt or equity issue. Small business requirements are therefore defined as being less that this amount.

131. The small business can sometimes raise funds by selling shares or notes to friends and business acquaintances of the entrepreneur.

Occasionally, investment dealers will place an issue with a small group of clients or with one or two investing institutions out of the few willing to participate in private placement. In a survey reported on by 103 investment dealers there were 47 who had offered a total of 217 small business issues in the past two years. Of this number only 18 were private placements.

132. The Industrial Development Bank has been Canada's best answer to the problem of financing small business. The I.D.B. reports having 1,364 loans totalling $71.2 million for an average of $52,000 per loan. Loans are only granted on the security of fixed assets. In surveying the attitude toward the I.D.B. the following criticisms were encountered: that its services are too slow; costs too high; liens on assets too tight; repayment requirements too heavy and that there was a tendency to force small business into fixed obligations. In spite of these criticisms it appears to us that the I.D.B. is doing a good job.

133. The prime suppliers of short term loans to small business are the chartered banks. Also, under the Small Business Loans Act, the banks can advance up to $25,000 in certain small businesses grossing less than $250,000 per year. The Government guarantees lending banks to the extent of 10% of the aggregate of such loans. Loans under this Act have not been as numerous as was originally anticipated. It has been indicated that the Government might increase the maximum to $50,000 and include businesses grossing up to $750,000. This would be advantageous. However, the Government should consider increasing its guarantee to 25% of the aggregate loans.

134. Public distribution of the securities of small business is made difficult by the reluctance of the chief lending institutions to participate in small stock and bond issues. Thus, the underwriter must rely on the retail buyer. The large investment dealer cannot afford to handle small issues but if an issue has sufficient merit an investment dealer can be found to distribute it, if it is in excess of $200,000. Major problems which dealers experience in financing small business are lack of depth and

experience in management; inability to withstand a recession; reluctance of the principals to accept partners; an insufficient amount of equity provided by the principals and the lack of marketability of small issues.

135. Certain industrial commissions assist small business through grants of land and commutation of taxes and some private corporations have been set up to finance the small business. In the main, the latter tend to require too large a share in the common stock.

136. In Britain the Industrial and Commercial Finance Corporation plays a valuable role in financing small business. This corporation is sponsored by a group of banks. The shareholding banks provide all the funds for its purposes. In the United States the Small Business Administration has contributed importantly to financing of small business ventures. This Administration licenses, supervises and helps to finance investment companies which serve as sources of equity and long-term loans to small business. About 425 of these investment companies with capital amounting to $1/2 billion have been established. Subject to certain limits they may borrow up to 50% of their capital from the Administration. Over 125 American banks are stockholders of these investment companies. Consideration should be given to establishing similar legislation in Canada.

137. It is important to emphasize that the largest pools of money in Canada, namely those of the banks and the insurance companies, are at present supplying no consequential amount of long-term funds for small business. If ways and means could be found to encourage these investing institutions to apply even a fraction of 1% of their portfolio investments to the securities of small businesses, a major contribution would result.

NON-RESIDENT INVESTMENT - Appendix M

138. Appendix M deals with certain aspects of non-resident investment in Canadian debt securities. Non-resident investment in equity securities is dealt with in Appendix J.

139. Foreign investment in Canada rose from $7.1 billion in 1945 to $20.6 billion in 1959. In 1959 U.S. investments in Canada totalled $15.7 billion. During the period 1946 to 1949, Canada was a net exporter of capital but her dependence on imported capital increased during the 1950's and in 1959 over 29% of gross capital formation was financed through foreign sources.

140. Direct investment accounts for approximately two-thirds of all foreign investment in Canada. In recent years, the U.S. has been the primary source of direct investment. Canadian tariff policy has encouraged foreign companies to open branch plants in Canada. The investment dealer has had little to do with direct investments as they have been almost entirely outside the realm of his operations.

141. In the area of portfolio investments however the dealer has responded to the huge demands for capital in Canada and sought out foreign markets for Canadian securities. Foreigners have, in large part, financed all the large pipelines, the development of the iron mines in Quebec, the Kitimat aluminum project, and, in a substantial part financed large hydro projects in most of the provinces and a great many municipal and provincial projects.

142. In the 1956 - 1960 period, external sales of new issues of provincial, municipal and corporate debt securities totalled over $2.8 billion. The major portion of these securities were payble in foreign currencies. External payment bonds are legal for many foreign investing institutions and were sold at yields below those of comparable Canadian pay securities. The latter are issued primarily for the Canadian market and while purchased by foreigners they are not nearly as acceptable to foreign institutions. The main foreign purchases of Canadian debt securities have been life insurance companies, pension funds, savings banks and the like. Non-resident insurance companies which write insurance in Canada buy Canadian pay securities to cover their liabilities. These purchases do not affect our balance of payments position.

143. It is interesting to note that the greatest flow of capital to Canada occurred when the dollar was at a substantial premium. This suggests that the exchange rate was a result rather than a cause of the capital flow. However large capital inflows in 1950 and 1951 were undoubtedly related to the fact that foreigners felt that the Canadian dollar was at an unnaturally low level.

144. Since 1950, yields on Canadian bonds have always been higher than those on comparable U.S. bonds. The lower interest cost of financing through external pay securities has appeared to be attractive to many Canadian borrowers. Undoubtedly yields in Canada during the 1950's were kept lower than they would have been by virtue of the large volume of securities sold in the U.S. Debt security sales were encouraged by the absence of Canadian withholding taxes on external payment bonds. Since late 1960 the Government has actively discouraged sales of securities abroad by asking provincial and municipal governments to finance at home and by imposing withholding taxes which reduced yields to certain foreign purchasers. This resulted in a substantial decline in the sales of debt securities to foreign investors, and a rise in the proportion of Canada's balance of payments deficit being covered by direct investments.

145. A growing country like Canada may need to import substantial amounts of foreign capital from time to time to ensure a rate of growth consistent with national objectives. It would seem desirable that where foreign capital is required, it should be sought in the form of debt rather than equity. In so far as is possible, Canadians should be encouraged to participate in the ownership of domestic enterprises.

TAXATION - Appendix N

146. In 1939, all levels of government in Canada took approximately 20% of the Gross National Product. By 1960, this had increased to 28.7% of a vastly increased Gross National Product. With the background of

rapidly increasing government spending in mind, it appears essential that the tax structure should be critically examined.

147. Growth of our economy depends on demand for the goods and services we produce. Growth is essential to the maintenance of a high level of employment. Today the heavy tax loads and the methods of applying them appear to have a profound effect on economic growth. Under these conditions, it is desirable that our whole tax system be re-assessed. At the present time, Queen's University in co-operation with the Canadian Tax Foundation is carrying out a study of the level and structure of taxation in Canada. While broad, this study will not encompass all of the areas which we believe should be examined.

148. The present tax system was formulated under pre-war conditions. Since that time, the Canadian economy has undergone substantial change. In addition to the United States, new large economic blocks have been formed which are influencing and will further influence our international trading patterns. It is probable that our tax system is quite unsuited to current circumstances.

149. The prime factor which should be kept in mind when considering the revision of the tax system is simplicity. In Canada today, taxes are not only high but also difficult to determine. Present patch work results in considerable effort being utilized in tax avoidance. Broadly speaking, the simpler the tax system the easier it will be for business to make decisions.

150. Another important goal in revising Canada's tax system should be to achieve a more equitable distribution of taxes - a distribution which would provide more incentives and less discrimination. We should strive for elimination of the various forms of double taxation. Certain groups such as co-operatives and credit unions should contribute their fair share of the tax load. Particularly careful consideration should be given to a reduction in the higher marginal rates of personal taxation which would

increase incentives. Is it right for an individual tax payer to pay higher rates than the largest corporations?

151. The use of indirect taxation to broaden the tax base should be carefully considered. In Canada almost 86% of the tax payers pay less than the average rate. If the revenues of government must be increased substantially, a broader tax base will be necessary. This could be achieved through indirect taxation. Indeed, it might be desirable to implement a higher sales tax in order that corporate income and personal income taxes might be greatly reduced. In Canada at present many individuals receive benefits but do not pay their fair share of the costs. This also applies to a number of corporate entities.

152. While taxation is punitive, it can be varied in such a way as to direct and encourage economic activity along desirable channels. Two important channels for Canada are those that would lead to increased exports and employment. An incentive of fairly large proportions must be granted to ensure that movement in the desired direction will occur. It might, for example, be desirable to permit industry to charge depreciation in excess of 100% under certain conditions.

153. In studying Canada's tax system, a full examination should also be made of systems in other countries, particularly those countries where production of primary natural resources is extremely important. Consideration of the way these countries have orientated their tax structures to foster economic objectives might prove to be very instructive.

154. Problems relating to distribution of corporate surpluses might be solved in a better manner than at present. Existing laws necessitate much wasteful expenditure of time and energy in legal manoeuvres. Consideration could be given to establishing a basic flat tax at the corporate level on all distributions to shareholders with such distributions then being tax-free in the hands of the shareholder. The establishment of the dividend

tax credit was a progressive move. Further steps toward the elimination of double taxation should be considered. While the dividend tax credit has been successful in encouraging Canadians to invest in equities, it has not noticeably enduced corporations to finance through equity rather than debt securities. Corporation tax levels are apparently sufficiently high that they provide positive preference for debt financing.

155. Any full study of the tax structure should include a more precise definition of income with a view to differentiating between income and capital gains. For Canada a capital gains tax is neither necessary nor desirable. Capital gains taxes can cause severe market dislocations and the costs of their calculation and collection are high.

156. The tax disadvantages experienced by Canadian individuals in the development of natural resources as compared with individuals in the United States should be eliminated. United States tax laws permit an individual to write off losses incurred in the development of natural resources. Absence of such a privilege in Canada may have contributed significantly to the high percentage of Canadian natural resources which are foreign controlled.

157. A prime objective in planning the revision of our tax system should be to provide a system which will assist the orderly growth of the economy. The government has been inclined to use increases in income taxes as a means of controlling inflationary pressures in boom periods. There has been no compensating policy of reducing income taxes during recessions. Canada needs to discover a positive approach to taxation through which the tax structure will be more closely linked to our long term economic and fiscal objectives. This will necessitate a sweeping revision of the present Income Tax Act. It is essential that a thoroughly competent body study our tax structure and our needs with great care. In the light of this study such a body could suggest a new system or a general revision of the old one which would be compatible with the requirements of the new era in which we live. To achieve this end, we recommend the establishment of a Select Committee to study and assess the entire tax structure of Canada.